

Before the
Federal Communications Commission
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of)

Federal-State Joint Board on)
Universal Service)

CC Docket No. 96-45

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Reply Comments of Citizens for a Sound Economy Foundation

Citizens for a Sound Economy Foundation (CSE Foundation) hereby offers these reply comments for the above-referenced proceeding. Founded in 1984, CSE Foundation is a nonprofit research and educational organization with 250,000 members and supporters in every state in the country. We have been active in a broad range of telecommunications policy concerns since 1988, addressing such issues as universal service, price regulation, and use of the electromagnetic spectrum.

The Telecommunications Act of 1996 requires the Commission to consider substantial reform of those policies designed to provide universal service. We believe that significant reform is necessary to meet the requirements set out by this legislation, but disagree with the comments by various parties in this proceeding that this requires an expansive definition of universal service. Rather, we urge the Commission to employ a model of universal service that focuses on explicit subsidies to narrowly-defined classes of recipients, as this will best meet the legislation's requirements for promoting both universal service and competitive markets within this industry.

CSE Foundation believes that comments by a number of parties regarding competitive bidding for universal service subsidies warrant further consideration by the Commission. In our original comments in this proceeding, we supported the use of auctions for subsidies to high-cost areas, and we reply herein to similar recommendations made by other parties. Under certain conditions, such a process should promote efficiency in serving a market, which in turn will lower the cost of this support and the resources that must be taken from elsewhere to finance it. We believe that this will speed the adoption of the universal service mandates of the Telecommunications Act of 1996 while simultaneously promoting the more efficient markets that benefit all consumers.

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I. Universal Service and the Principles Needed to Promote It

Section 254 of the Telecommunications Act of 1996 presents a number of principles to preserve and advance universal service, including a description of those eligible for assistance and the requirement that such assistance be financed in a non-discriminatory manner.¹ While the implementation of Section 254 will play a critical role in reform of this industry, universal service exists as part of a larger body of issues discussed in the legislation under the theme of developing competitive markets.² Other issues include the removal of barriers to entry, interconnection, and other details involved in promoting competition in local markets, for which separate proceedings will be held.³ The Act and the numerous proceedings following it can thus be seen as an effort to promote the goal of a competitive telecommunications market that fosters universal telephone service to all who desire it.

CSE Foundation believes that, as provided for in Section 254(b)(7) of the Act, the Commission should adopt two principles for universal service in addition to those described in the legislation and in the above-referenced Notice of Proposed Rulemaking.⁴ These additional principles are both consistent with the new legislation and necessary for successful implementation of its goals. Specifically, we recommend that all subsidies should be simple, direct, and explicit, and that the contributions of those paying for these subsidies be clearly

¹ Telecommunications Act of 1996, Sec. 254.

² Ibid., Title I.

³ See, for example, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Notice of Proposed Rulemaking, CC Dkt. No. 96-98 (April 19, 1996).

⁴ Telecommunications Act of 1996, Sec. 254(b), and Federal-State Joint Board on Universal Service, Notice of Proposed Rulemaking and Order Establishing Joint Board, CC Dkt. 96-45 (March 8, 1996) ("NPRM"), Para. 3.

specified and apparent to all. These principles will help ensure that the universal service policy adopted by the Commission meets the 1996 Act's requirements of offering "specific, predictable and sufficient" support financed by "nondiscriminatory" contributions.⁵

II. Other Principles for Defining Universal Service

The number of parties filing comments before the Commission in this proceeding total well over two hundred. Such an unusually large number of participants reflects the amount of resources at stake in the Commission's final ruling. That is, this proceeding will largely determine who will receive universal service subsidies and who will pay for them. Both potential recipients and potential contributors thus have significant reason to make their preferences known.

CSE Foundation recognizes that many commenters agree with the Commission in its definition of basic services that should be supported, including voice-grade access, touch-tone service, single party service, access to emergency service, and access to operator services.⁶ In our comments, we propose that subsidies be limited to basic voice-grade access as well as emergency services, noting that additional subsidies unfairly burden those customers who finance this assistance. We believe that in no case should the Commission expand universal service beyond services such as these.

We specifically object to the proposals by various commenters who recommend a notably more expansive definition of universal service. For example, CSE Foundation does

⁵ Telecommunications Act of 1996, Sec. 254(b)(5) and Sec. 254(b)(4).

⁶ NPRM, Para. 16.

not agree with the premise that a comprehensive universal service package should require support for voice mail or other specialty services.⁷ Moreover, we strongly disagree with the argument made by some commenters that universal service must be defined broadly in order for the principles of universal service "to have any real significance."⁸ As an example, some have suggested that the requirement for "access" to the network should also include the right to "use" the network, and that flat rate service should therefore be included in any definition of universal service.⁹ However, while flat rate service is the preferred pricing arrangement for many consumers, mandating this service for all subscribers simply serves to restrict the options of an unfortunate few. In fact, some may desire a more limited service at a price lower than can be offered for flat rate service. Since such consumers are more likely to have low incomes, restricting service options simply punishes those most in need.

CSE Foundation stresses, to the extent the definition of universal service becomes more expansive, it becomes more expensive. Significantly, the costs of any such policy will likely be passed on to the average telecommunications consumer, and may hurt those who do not qualify for subsidies yet cannot afford to pay the inevitable costs. Subsidies to high-cost

⁷ NPRM, joint comments of the United States Catholic Conference, National Coalition for the Homeless, Washington Legal Clinic for the Homeless, American Women's Roundtable, Community Technology Institute, Consumer Action, Farmworker Justice Fund, Fifth Street Connection, Heartland Alliance for Human Needs and Rights, Interstate Migrant Education Council, National Association of Migrant Educators, Marcia Zashin, Education Consultant to Cleveland Public Schools and Project Act, Migrant Legal Action Program, and Vermont Migrant Education Program.

⁸ NPRM, joint comments of People for the American Way, Alliance for Community Media, Alliance for Communications Democracy, Benton Foundation, Center for Media Education, League of United Latin American Citizens, Minority Media and Telecommunications Council, National Council of La Raza, and National Rainbow Coalition.

⁹ NPRM, initial comments of the American Association of Retired Persons, Consumer Federation of America, and Consumers Union.

rural areas, for example, would impose a burden on poor inner-city residents, even under the most efficient taxing mechanism. The use of a fixed monthly surcharge, a usage-based tax on interexchange calling, or the practice of averaging rates across low-cost urban and high-cost rural areas all would inflict some cost on the average urban customer, rich or poor.

At the same time, high-cost area subsidy recipients -- like those who finance them -- include both rich and poor.¹⁰ Impoverished individuals in rural communities benefit along with wealthy customers with vacation homes in isolated areas. CSE Foundation therefore maintains that the most efficient and fair arrangement is to define universal services as narrowly as can be permitted under the Act.

III. Specific Policies and the Promise of Reform

CSE Foundation believes that the subsidy for rural and high-cost subscribers presents perhaps the most expensive and difficult-to-administer policy for a universal service program. The Telecommunications Act of 1996 requires that rates and services in rural areas be "reasonably comparable" to those in urban areas,¹¹ though no explanation is given as to the

¹⁰ See Leighton, Wayne, "Consumer and Cross-Subsidies: An Interest Group Theory of Telecommunications Regulation," Ph.D. dissertation, George Mason University (1996), and "Telecommunications Subsidies: Reach Out and Fund Someone (Whether You Want to or Not)," Citizens for A Sound Economy Foundation Issue Analysis, January 5, 1995. See also, Kaserman, David and John Mayo, "Cross-Subsidies in Telecommunications: Roadblocks on the Road to More Intelligent Telephone Pricing," Yale Journal on Regulation, Vol. 11, No. 1 (1994). For a more detailed analysis of the subsidy from urban to rural areas, see Telecommunications Industries Analysis Project, "What is the Price of Universal Service? Impact of Deaveraging Nationwide Urban/Rural Rates," TIAP, Cambridge, MA (1995). For an analysis of subsidy flows from interexchange callers to local callers (including both urban and rural), see Makarewicz, Thomas, "Efficient Telecom Pricing: Who Stands to Benefit?" Public Utilities Fortnightly (March 15, 1996); and the discussion Crandall, Robert, After the Breakup: U.S. Telecommunications in a More Competitive Era, The Brookings Institution, (1991).

¹¹ Telecommunications Act of 1996, Sec. 254(b)(3).

standard for reasonable rates or how rates and services should be compared across areas that differ in population-density, terrain, and other factors. As a result, the Commission has been given a tremendous responsibility to provide a workable and cost-effective framework for administering this subsidy.

Most commenters addressing subsidies to rural, insular and high-cost areas support one of two approaches: 1) a focus on Total Service Long Run Incremental Cost (TSLRIC) or some measure of imbedded cost, or 2) use of the Benchmark Cost Model (BCM). Both of these approaches have limitations -- which we noted in our original comments -- though either may have usefulness in the administration of subsidies to a monopoly provider.

More importantly, however, we stress here that one of the key elements of the Telecommunications Act of 1996 is its focus on competition.¹² Therefore, as far as it is possible, the Commission should attempt to incorporate in its new subsidy arrangement those mechanisms that encourage competition. We believe that the competitive characteristics that accompany auctions offer a particularly promising mechanism. Competition for universal service subsidies in rural markets will do more than just lower the burden of supporting this market, it will also help encourage new and better technologies to come forward in areas with limited services.

A number of organizations put forth arguments for some type of competitive bidding process or auction.¹³ While we believe that auctions will best identify and reward the least-

¹² As mentioned above, Part II of Title I of the Act focuses on developing competitive markets. See also the Joint Explanatory Statement of the Committee of Conference.

¹³ Among the organizations whose comments mention support for some type of auction: Association for Local Telecom Services, Continental Cable Vision, Inc., Florida Cable Television Association, GTE Corporation, National Cable Television Association, New York Consumer Protection Board, Personal

cost method of providing a specified level of service, we acknowledge that this approach -- like any other -- will not be perfect. This is to be expected when competitive processes are implemented in regulated and subsidized markets. Nonetheless, we argue that the lack of any competitive process will only increase the incentive for poor management of costs by regulated firms.¹⁴

In the initial comment round, a variety of organizations presented models of auctions that varied in their level of detail or method of implementation. GTE Service Corporation (GTE) has offered an especially well-researched and detailed proposal for an auction process in its comments on this proceeding and in previous comments before the NTIA.¹⁵

Under the GTE plan, eligible telecommunications providers would be required to enter bids for the amount of support they would need to serve in a specific market (above that paid by the subscriber), with a geographic area based on Census Block Groups (CBG). Other carriers could serve this market without participating in the bidding process, but they would not be eligible for Carrier of Last Resort status and would not receive support.

The amount of the subsidy under the GTE auction plan would be determined by the lowest bid, and this amount would be distributed based on the number of subscribed customers served by an eligible provider. In order to remain eligible, a provider must have

Communications Industry Association, Time Warner Communications, Inc., and Wisconsin Public Service Commission.

¹⁴ For a discussion of the disincentives faced by regulated firms -- especially those under traditional rate-based regulation, see, Leibenstein, Harvey, "X-Efficiency, Intrafirm Behavior and Growth," American Economic Review, Vol. 56 (1966), pp. 392-415.

¹⁵ NPRM, comments of GTE Service Corporation. See also, Before the National Telecommunications and Information Administration, In the Matter of Inquiry on Universal Service and Open Access Issues, Dkt. No. 940955-4255.

successfully completed three rounds of bidding, in each round submitting either the lowest bid for a market or an offer to serve for a subsidy within a certain range of this low bid. This requirement helps to provide an incentive for bidders to submit low bids, since potential recipients may be disqualified by a competitor with a significantly lower bid. After some pre-established period of time -- say, five years -- a new bidding process would take place.

While innovative and potentially quite useful, the GTE model -- at least the simple model as presented here -- may encounter some objections. Specifically, at least four potential objections may be made, though we believe that these concerns are resolvable and that the GTE approach or a similar model can respond to them:

- 1) There may be insufficient economies of scale when an auction focuses on a Census Block Group, since this encompasses only 400 households.

This point actually encompasses two potential problems. If a service area is too small and focused, there may be virtually no possibility of a firm being able to plan production so as to enjoy economies of scale. On the other hand, if a subsidy area is sufficiently large to plan for such production (say, an exchange with 100,000 subscriber lines) then there exists a high probability of cost differences within the service area in question. Such cost differences may make it difficult for smaller alternative providers to compete, as these firms may have a comparative advantage in serving just part of a market.

Part of the solution to these two problems might be found in the auctions of licenses for personal communications services (PCS).¹⁶ In this case, the FCC used a simultaneous

¹⁶ For a discussion of this competitive bidding process as applied to the PCS auctions, see McAfee, R. Preston and John McMillan, "Analyzing the Airwaves Auction," Journal of Economic Perspectives, Vol. 10,

ascending auction to allocate a large number of licenses among many potential users. This type of auction entails open bidding that takes place simultaneously for all available licenses, and is conducted over multiple periods.¹⁷ The result is that all bidders know the valuation given to each license by each contender as prices rise in the bidding process. This, in turn, allows each bidder to know the cost of providing a particular service to a particular area. With PCS, for example, a license for the same frequency over many geographically-contiguous regions may be particularly valuable, and would thus be bid up in price.

The experience with PCS auctions has particular relevance to auctions for subsidies to serve high-cost areas. While there is a definite need to focus on small areas so that different types of providers may plan to serve the many different markets, only service that spans many contiguous areas will enjoy economies of scale. Under a simultaneous ascending auction, potential providers can see what other providers require to offer service in many different areas, and will thus have some basis to estimate how much they must bid to be able to operate within a larger area.¹⁸

No. 1 (1996) pp. 159-75. For a more general description of auction models, see Riley, John and William Samuelson, "Optimal Auctions," American Economic Review, Vol. 71 (1981) pp. 381-92, and Vickrey, William, "Counterspeculation, Auctions and Competitive Sealed Tenders," Journal of Finance, Vol. 16 (1961) pp. 8-37.

¹⁷ The FCC auctions for PCS used a three-stage bidding process, which is also the approach taken by GTE. Since the intent is to select that provider who will serve for the least subsidy -- rather than pay the most for a license -- this is technically a simultaneous decreasing auction. Under either label -- simultaneous increasing or decreasing auctions -- the result is still the same. That is, the bidder who can use the resource most efficiently will offer more (or, in the case of subsidies, agree to take less) than all other providers.

¹⁸ This does not mean that the winning provider would enjoy exclusive rights to serve an area upon winning an auction, though a PCS auction winner does enjoy exclusive rights to the license won. Rather, for the high-cost subsidy auction, the purpose of a simultaneous process is to give the bidder some estimate of the subsidy to be received, thus making large scale planning easier.

2) There may be insufficient incentive for providers to bid aggressively, either because of a lack of competition, or because the "winning" bidder does not receive a sufficient reward for having revealed its true costs of service. In other words, a low-cost provider might bid to receive the same level of support as higher-cost providers simply because it has no incentive to ask for less.

This risk of the lowest bidder offering an inflated subsidy requirement is especially significant in those markets with no competitor or very little competition. For this reason, the advantages of a competitive bidding process may only apply to those markets in which competition -- or at least potential competition -- is present. This is a position taken by many auction supporters, and is also mentioned in the NPRM.¹⁹

At the same time, however, the Commission states that it believes that "competitive markets may develop even in high-cost areas."²⁰ We add that many markets may see several potential competitors come forth, including local exchange carriers from neighboring markets, competitive access providers, wireless providers, cable television providers, and utility companies. What might be the best model for determining the competitiveness of a market is a difficult issue that we defer to the Commission and the many others who have discussed alternative approaches in this proceeding. Instead, we again simply stress that the competitive process will best serve the goals outlined above, and should be pursued wherever possible.

As to the second problem -- the lack of an incentive for a carrier to offer its lowest

¹⁹ See, for example, comments by the New York Consumer Protection Board and the Wisconsin Public Service Commission, and NPRM, Para. 37.

²⁰ NPRM, Para. 37.

possible bid -- we believe that appropriate mechanisms can be developed to encourage low-cost providers to bid aggressively. As described above, GTE proposes to mitigate this problem by requiring all subsidy recipients to have bid within a certain range of the lowest bid. Another potential solution would be for the lowest bidder to receive its requested amount of subsidy, while all higher bidders receive a reduced amount. This type of incentive was suggested in comments by Time Warner Communications, Inc., and we believe that it deserves further consideration by the Commission.²¹

To encourage the lowest possible bids for a given level of service, the reduction in subsidy for higher bidders could equal the difference between their submission and the lowest bid. Thus, if the lowest bid is for a \$30 monthly subsidy (in addition to a fixed amount paid by the subscriber), then eligible providers bidding \$40 would receive \$10 less than the winner's subsidy, for a total per-subscriber subsidy of \$20 (\$30 - \$10). This approach encourages the least-cost provider to bid closer to its true cost, since offering the lowest bid gives it an advantage over its rivals.

CSE Foundation notes that a subsidy allotment based on proximity to the lowest bid is but one of what may be many potential solutions to the problem of incentives to bid at lowest possible cost. We reiterate that the proposal by GTE to require subsidy recipients to have bid within a certain range of the lowest offer is an attractive solution, although we are concerned about the potential for limiting new entrants by restricting eligibility for a subsidy only to those bidding in the initial auction. We also note that the GTE model includes other

²¹ NPRM, comments by Time Warner Communications, Inc. See also the paper accompanying this company's submission, "Funding Universal Service: Maximizing Penetration and Efficiency in a Competitive Local Service Environment," A Time Warner Communications, Inc., Telecommunications Policy White Paper.

modifications that may help to further encourage low bidding.²² Finally, we suggest that an optimal model for allocating high-cost area subsidies might incorporate a combination of approaches.

3) There may be no incentive for a new provider to offer service if it cannot reasonably expect a minimum amount of subsidy for a set period of time.

In both competitive and less-competitive markets, the need to finance an investment over many years is particularly important when large-scale, capital-intensive projects are involved. From this necessity comes the producer's desire to contract for an exclusive right to serve a given market over many years -- or in the present case, exclusive rights to receive a subsidy in a market. While in theory competition for these exclusive rights would drive prices down to competitive levels,²³ it also means that alternative providers with lower costs or better ways to serve consumers would be kept out. For this reason, CSE Foundation opposes granting any exclusive rights.

Nonetheless, we recognize that, for high-cost service areas, potential providers will certainly desire some guarantee that the support they receive from the auction process will in fact be made available to them for a reasonable amount of time and at the arranged level.

²² For example, the GTE model modifies the FCC's use of simultaneous ascending auctions. Under the FCC's model for PCS licenses, bidders were required to actively bid in the first stage on at least one-third of those licenses in which they had an interest, with this requirement increasing to two-thirds of their desired licenses for the second stage and all licenses in the final stage. The purpose of this requirement is to limit the ability of bidders to understate their interests early in the process. The GTE model proposes changing these activity requirements for the first, second and third stage to 80 percent, 90 percent, and 100 percent, respectively.

²³ See Demsetz, Harold, The Organization of Economic Activity, Vols. I and II, Blackwell, Cambridge, MA (1989).

This can be accomplished, as GTE proposes, by setting the subsidy for a period of time -- for example, five years.²⁴ The bidding will then proceed according to the calculations made under these constraints. It is important to note, however, that while the subsidy is guaranteed over the life of the contract, the market share of the provider is not.

4) There is no allowance for post-auction providers to enter a market and receive support during the length of the subsidy contract.

GTE proposes to exclude from eligibility for subsidies any provider that has not participated in the auction process. This is intended to resolve the incentive problems outlined above. However, it also limits the ability of significant new (post-auction) technologies to benefit consumers during the life of the subsidy contract. It is conceivable, for example, that consumers could be denied access to a superior service for three or five years due to an exclusive contract.

CSE Foundation believes that this element of exclusivity could pose a significant problem.²⁵ As a potential solution, we tentatively suggest that the right to receive a subsidy for a particular market be made transferable. Under such an arrangement, a recipient (or multiple recipients) would still receive a set subsidy for each subscriber it serves. But, should an alternative carrier without such a subsidy discover a lower-cost means to provide

²⁴ This is not to say that a capital investment in telecommunications infrastructure can or cannot be recouped over five years. However, under such a time constraint, a potential provider with an investment needing six years over which to finance would not necessarily be kept out of the market. Rather, this provider would simply raise its costs to reflect the risk associated with an uncertain return in year six, a common calculation for many businesses.

²⁵ We note that some plans do not necessarily exclude non-bidders from eligibility, but any plan that provides rewards to bidders will disadvantage non-bidders.

the same service, the alternative carrier could buy the subsidy rights from any currently-eligible provider. Both parties would have an incentive to make this exchange.

We acknowledge that new providers might earn an economic profit by purchasing a right to a subsidy and subsequently earning a net return well above its costs. However, we note that such profit would be temporary, as it would likely dissipate in the next bidding round after the end of the current contract period. Moreover, we point out that a brief period of economic profits is an appropriate reward for bringing forward a cost-saving technique that will soon the total cost of the subsidy. Such a reward approximates the brief, economic profits earned by innovative firms in competitive (and unsubsidized) markets.

We encourage the Commission to consider other ways in which new, post-auction providers might be able to serve customers at any time and still receive subsidies. We also stress that any new provider not needing support should be able to enter the market without restrictions or qualifications at any time.

CSE Foundation believes that the above-mentioned solutions offer an important first step toward implementing an auction process in unsubsidized markets. We acknowledge that no subsidy mechanism will be perfect, but stress that only by emphasizing a competitive process will rural, insular and high-cost markets enjoy the innovation, efficiency and lower costs that accompany competition.

Finally, we note that a number of commenters argue that an auction process would be unwise due to the incentives for providing low-quality service. These organizations maintain that establishing a subsidy based on the lowest offered bid encourages the competing firms to provide extremely low-quality service. While this observation may be true as stated, it

misses the point in at least two ways.

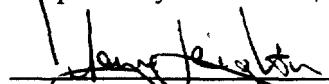
First, an auction process should still give consumers a choice of providers, allowing consumers to avoid low-quality providers. Second, a subsidy to a high-cost area is a payment to guarantee a certain level of service, no matter how the subsidy value is determined. Any other model or technique to determine an appropriate subsidy is susceptible to the same problem. For this reason, all models assume a certain level of regulatory oversight to ensure that the service for which a subsidy is paid is in fact delivered. In this regard, therefore, an auction process is no different from any other approach to determining the level of a subsidy.


IV. Conclusion

As shown by the large number of commenters to the NPRM, the issue of universal service generates considerable interest. This is because the Commission has both the authority and the responsibility to implement a universal service program that may ultimately be given an expansive definition. CSE Foundation stresses, however, that an expansive definition will necessarily imply an expensive definition, and we add that a more broad approach does not appear to further help those in need of assistance. Rather, a broad universal service program will simply require more resources to be taken from elsewhere in the market, a burden that is likely to fall disproportionately on less-fortunate subscribers. Therefore, we urge the Commission to pursue a universal service program that is limited to a small, well-focused subsidy to specific subscribers, and that finances such a subsidy by a simple, flat, and non-discriminatory tax.

We further note that subsidies such as those to rural, insular and high-cost providers are particularly vulnerable to inefficiency, a result that is largely due to a lack of market discipline and the subjective nature by which these subsidies are often calculated. An auction process may provide the best approach to designing these subsidies in an efficient manner. The contributions of other commenters, as well as the suggestions discussed above, offer the Commission a useful framework for dealing with the difficult -- and expensive -- issue of assisting high-cost and other subscribers. We urge that these suggestions be included in the Commission's approach, and note that this is perhaps the best means to incorporate the 1996 Act's goals of universal service and competition.

Respectfully Submitted,


Wayne A. Leighton, Ph.D.
Senior Economist for Regulatory Affairs


James L. Gattuso
Vice President for Policy Development

Citizens for a Sound Economy Foundation
1250 H Street, NW, Suite 700
Washington, DC 20005
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